National Council of Nonprofit Associations

National Voice • State Focus • Local Impact

July 21, 2004

Senate Committee on Finance
Attn: Charitable Table Roundtable
Rm. SD-203
Dirksen Senate Office Building
Washington, DC 20510-6200

Dear Senator Grassley, Senator Baucus and Senate Finance Committee Members:

The National Council of Nonprofit Associations (NCNA) is pleased to submit these comments for the July 22, 2004 roundtable discussion in response to the *Staff Discussion Draft o*n the subject of charity oversight and reform. These comments are slightly revised from our initial comments submitted earlier (dated July 6, 2004). NCNA is a membership-based organization organized as a nonprofit corporation under state law and exempt from federal income taxation under section 501(c)(3) of the Internal Revenue Code of 1986, as amended (the "Code"). We represent a network of 38 state and regional associations of nonprofits with a membership base of over 22,000 nonprofit charities nationwide. The majority of our members and their members are organized as nonprofit corporations under state law and exempt from federal income taxation under Code section 501(c)(3). Our membership reflects the majority of the charitable sector, that is, organizations that have annual revenue budgets of less than $500,000. These organizations represent 70% of the total number of nonprofit charities that file IRS Form 990. In addition, many of the members of state associations have revenues below the required filing level of $25,000.

We must state emphatically that the majority of charities are operating legally and ethically and are adhering to their stated mission as outlined in the IRS Form 1023 that they filed in order to receive 501(c)(3) status. It is disheartening that the actions of a few bad actors, who are in no way representative of what the charitable sector offers our society, has led to a Senate Finance Committee examination of the actions of the sector. We hope that the results of this examination lead to a removal of these bad actors so that the sector can return to serving communities in need and strengthening the public's trust in this valuable resource.

NCNA's state association members provide infrastructure support to their local nonprofit members through workshops, discount programs, communications, technical assistance, and referral services, and serve as call centers that answer questions about

regulatory and legal requirements. Through their efforts, we ensure that nonprofits are complying with the legal and ethical requirements that guide the work of the nonprofit charitable sector. As mentioned above, most of the organizations our members serve are small and mid-sized nonprofit charities. Therefore, our comments and recommendations are tailored to reflect the impact of the Committee's actions on these organizations. We cannot stress enough the importance of seeking and including input from these organizations as you move forward and consider proposed changes that impact the work of these community-based organizations. Some of our state association members have submitted comments on behalf of their own members, and we encourage your strong consideration of the recommendations they have offered as representatives of the voices of small- to mid-sized nonprofit organizations

No entity has greater interest in keeping bad things from happening to good charities than charities themselves. We support efforts that ensure that nonprofit charities operate not only legally, but in ways that do not tarnish the image of the good and vital work done by the majority of nonprofits. Recent media reports of misdeeds and abuses have uncovered practices that, although not always illegal, raise questions about the nature of the practice and who benefits from it. To make sure the charitable sector operates effectively, efficiently, and true to its mission is the concern of all, and we applaud the attention the Committee is addressing to this issue. Developing regulations and enforcement efforts to identify, investigate, and correct bad behaviors is as important to those of us in the nonprofit sector as to the Committee and the general public. These efforts must proceed and result in the application of fixes that are reasonable, appropriate, and not overly bureaucratic. The Committee can be assured that their attention to the issues under consideration has already had an impact by encouraging many of us in the nonprofit sector to reflect on our own operations and practices. We appreciate this opportunity to share our suggestions so that we do in fact keep bad things from happening to good charities

Overview Comments

It is the case with all sectors – public, for-profit, and not-for-profit – that there are a few egregious examples of abuse that can taint an entire industry. We saw this most recently in the for-profit sector with the Enron, WorldComm, and other public company scandals. These abuses led to significant changes by Congressional action through the Sarbanes-Oxley legislation. There are currently fifteen states considering similar legislation for the nonprofit sector. Although some aspects of Sarbanes-Oxley can apply to nonprofits (and NCNA has endorsed those that can be directly and voluntarily adopted by nonprofits) there are valuable lessons that can be gleaned from the implementation of Sarbanes-Oxley that the Committee should review as it continues this process. For one, consider the cost of implementing any new legislation. Recent reports reveal that the cost of implementing new rules of Sarbanes-Oxley incurred by the business sector will be $5.5 billion this year, according to a recent survey of CEOs.

Additional reviews of the business sector reveal that problems still remain in financial auditing practices even after Sarbanes-Oxley has been implemented.

We accept the general premise that the nonprofit sector should be held to higher standards, as we are defined by our work done not for our own personal or organizational gain, but to serve others. All 501(c)(3) organizations undergo scrutiny by the IRS before obtaining tax-exempt status. On the surface, this can be viewed as a "certifying process." After this initial determination, the monitoring of our actions - and whether they are in fact principled and ethical - has been left in large part to each organization or to associations that we might be affiliated with. The rash of media coverage in the last couple of years has raised serious concerns about the wisdom of self-enforcement and whether it is time to create a more structured and punitive system of regulatory enforcement.

To fully address this issue we must recognize that we currently have laws on the books that address the current examples of abuse. Rather, it is the enforcement aspect that has been largely at fault. The IRS currently has the legal authority to correct any of the concerns addressed by the committee; however, as the hearings have revealed, the IRS does not have the resources (personnel or financial) to enforce the laws. NCNA has long advocated that sufficient support and funding of IRS oversight and enforcement efforts must happen before we consider additional efforts. It is wise to fix what is broken before moving on to costly and burdensome new reporting systems. New regulations will overload an already overburdened system – both for the enforcement entity and the nonprofits themselves. Only if the existing rules and regulations are found to be insufficient when fully and properly enforced should we move on to changing existing laws and rules.

At no time in our history has information about the sector, particularly financial information, been more openly and publicly available. For example, through the efforts of the National Center for Charitable Statistics (NCCS), GuideStar, the Nonprofit Sector Research Fund, and the Foundation Center, we have information about the size and scope of the sector, effective practices of nonprofits, and giving and volunteerism. The compilation of this data has been driven and funded by the nonprofit charitable sector itself. The public sector has had little investment and interest in compiling relevant statistics about this growing and vital sector, making these efforts small in comparison to the data gathered about the for-profit sector.

In recent years, many nonprofit sector infrastructure organizations have developed systems to provide guidance in a self-enforcement manner. These include efforts by large national associations (i.e., American Association of Museums) and state level organizations (Maryland Nonprofits). Some of these efforts have proven to be quite effective and informative for members of these groups. Other approaches have had minimal impact - often due to lack of resources and outreach. One can imagine how far

these efforts might have progressed with hefty financial investments. Congress can work with these groups, as noted in the *Staff Discussion Draft,* to encourage the support of such efforts to "clean up our house."

Senate Finance Committee Staff Discussion Draft

NCNA's response focuses on those items in the *Staff Discussion Draft* that are most applicable and of greatest concern to the segments of the nonprofit charitable sector that we and our state association members represent.

We used two key principles to review the recommendations in the draft document:

1. ***Proactivity***: While we recognize the need for regulation, these policies should be proactive in helping nonprofits avoid getting into trouble, versus solely reactive. An emphasis on education, training, and technical assistance is crucial for preventing bad things from happening to charities that want to be good - which is likely to happen if rules, regulations, and reporting requirements are unclear and inconsistent between federal, state, and local entities. We must take care not to create obstacles to the work of those who want to help others and make a difference in their communities.

2. ***Reasonableness***: The recommendation should be reasonable and focused on the problems (abuses) that we are trying to solve. As emphasized above, thousands of nonprofits play by the rules and adhere to their mission of advancing the public good. Rules and regulations are often developed in response to the exceptions - those relatively few organizations that do not play by the rules. Developing effective enforcement tactics that target these exceptions - with minimal distraction from the mission-driven activities of the rest - should be the guiding principle for any new regulation and/or enforcement efforts.

A. Exempt Status Reforms

1. Five-year review of tax-exempt status by the IRS. We agree with the general recommendations for a five-year review completed at the state level. Copies of articles of incorporation, by-laws, and conflict of interest policies are already required by federal and/or state law, and should be requested *only if* significant changes have been made to the documents already on file with IRS. The IRS should maintain a master database that has this information readily available for all organizations that they have reviewed. The review should be a simplified form that is certified by the CEO/Executive Director and Board Chair that the organization is still operating under the same definitions as stipulated in the determination letter. The sliding fee scale should include no fees for

organizations under a certain baseline budget. We suggest this amount to be $100,000 or less. Organizations that do not file should be given ample notice that they are not in compliance and that their exemption status is subject to removal. An unfortunate reality is that there is a high turnover rate for nonprofit staff, particularly at the executive director level, and new management staff may not be aware of the five-year reporting timeline for their organization. They ought not be penalized if report deadlines are not readily accessible.

The additional request for organizational practices is not clearly stipulated, nor does it adequately explain what will result from the submission of such information.

3. Supporting organizations. Total elimination of Type III supporting organizations without recognition of certain exemptions would cause unnecessary harm to those charitable organizations that are caught in the middle. That is, social action groups, unions, agriculture groups, and trade and professional associations that conduct activities through such support groups but do not qualify under Code 501(c)(3). In addition, there are current laws on the books that can handle abuses and misuses of this category; again it comes down to effective enforcement of existing laws.

B. Insider and Disqualified Person Reforms

1. Apply private foundation self-dealing rules to public charities and modify intermediate sanction compensation rules and 2. Expand the definition of disqualified person. The application of self-dealing transactions to public charities, particularly small and mid-sized organizations, will cause undue hardship. Many of these organizations have active "working" board members that provide valuable services to smaller organizations, such as legal, accounting, and program services. The involvement of these individuals can save the organization thousands of dollars in fees for services that they cannot afford but which are critical to the operations of the organization. At the present time the "intermediate sanctions" excise tax provisions under Section 4958 of the Internal Revenue Code already impose serious penalties on unfair and abusive transactions. Many governing bodies have established and implement conflict of interest and self-dealing policies that address these types of situations.

4. Compensation of private foundation trustees. The general practice of private foundations is not to pay compensation to their trustees. Those who do pay compensation have no guidelines on what is reasonable compensation and whether these amounts are eligible to be included in the "payout percentage." Therefore, general guidelines should be established to ensure that a foundation is in line with general agreed to principles that include benchmarks from

comparable institutions. The development of such guidelines should include representatives of the foundation and charitable sector, including those that monitor the activities of foundations.

C. Grants and Expense Reforms

1. Treatment of administrative expenses of nonoperating foundations. Nonprofit charities have long had an interest in the payout provisions of foundations and the expenses associated with the payout provision. We recognize that there are administrative costs that are associated with providing grants. These costs should be reasonable and necessary based on the activities provided to grantees and a scale created by the IRS. Costs beyond this should not be allowed as part of the qualifying distribution unless the foundation can provide supporting documents.

2. Encourage additional grant-making by private foundations. To encourage foundations to pay out more than the current 5% rate is an excellent example of using incentives to support nonprofits.

3. Limit amounts paid for travel, meals, and accommodation. Utilizing current policy and practices of the federal government might seem like a reasonable approach to apply to foundation and charity travel. However, unlike the government, foundations and charities do not have the purchasing power to negotiate low rates for travel and accommodations. Thus, it is likely that foundations and charities will find they cannot reasonably operate under the limits imposed by this recommendation – unless the government extends the use of government rates to nonprofits and foundations.

D. Federal-State Coordination of Actions and Proceedings

1. Establish standards for acquisition/conversion of a non-profit. There is a need for some form of national standardization governing for-profit acquisitions and conversions of nonprofit organizations. While many states do use the "profit" to establish foundations that continue the charitable mission of the organization (often health care related), there is often pressure to apply the profit for other purposes. More problematic, however, would be the inclusion of the IRS as a full partner in the conversion proceeding with a one-year window for disapproving the transaction. Experience has demonstrated that these transactions are extremely complex and time-consuming. A suggested approach is to develop a standard procedure for review which would be mandatory for all state charities and state (and federal) charity regulators. The IRS would be required to be given notice of a proposed conversion. If the Senate wishes to participate in this

process, it could define the form that participation would take and shorten the waiting time for a response to no longer than four months.

Suggested legislation should include:

a. the affirmative acknowledgment that the assets of the nonprofit organization are charitable assets which must be used for a purpose similar to that of the converting entity;
b. a definition of the terms "charity official", "conversion", "acquisition", "merger", "acquirer", "control", and "healthcare charitable trust";
c. a procedure which sets forth the requirement for notice to government officials (both state and federal) of the proposed transaction;
d. a formal process for review of the proposed transaction including timelines, public hearings, any conflicts of interest, fair market appraisal of the assets of the charitable organization, the name, address, and financial condition of the acquirer, reasons for the transaction, and copies of all pertinent documents;
e. a plan for the use of the charitable assets after the conversion which mirror as closely as possible the original mission and vision of the entity under conversion; and
f. a strengthening of the power of the charity official to disapprove the transaction and, if necessary, invoke the power of the court in protecting the public interest.

2. Provide States the authority to pursue federal actions. This should be done with financial support from the federal government. Currently, states do not have the capacity to enforce state and federal law violations. Remove current legal barriers that prohibit the IRS from sharing information with state officials about cases under review. Currently, many state charity officials only learn of federal (IRS) investigations after the fact or during an inquiry of the charity, another reminder of inefficient information-sharing amongst the various federal and state entities.

E. Improve Quality and Scope of Forms 990 and Financial Statements

The general problem with filing Form 990 is not due to lack of effort or malfeasance on the part of charities, but rather to lack of information and standards on how to file the forms. Two of the proposed reforms that are included in the *Staff Discussion Draft*, Standards for Filing and Electronic Filing, are the only two that will significantly address the concern for "accurate, complete, timely, consistent and informative reporting."

Mark Pacella, president of the National Association of State Charity Officials (NASCO), testified that his members (state charity officials) serve as "primary

regulators over public charities and most likely pursue breaches of fiduciary duties of loyalty, care and good faith." He stated that most breaches result not from bad actors as much as inept managers. We cannot overemphasize the need to provide technical assistance, training, and additional informational materials to assist organizations in understanding and complying with regulations and legal requirements. The current problem again is due lack of resources to fully enforce the laws that are currently on the books and to catch the bad actors and close down their operations when necessary.

1. Require signature by Chief Executive Officer. This practice is usually in place given that the Form 990 requires an "officer" signature. The problem has been that the Forms are usually filed by the auditor, CPA, or accountant of an organization. Although the CEO/Executive Director might have the "processes and procedures" in place, there may be differing opinions as to what is to be included in the various attachments and expense line items. This is in part due to lack of uniformity and clarity. Uniformity of definitions should be established and training and/or technical assistance offered to the CEO/Executive Director and Board Chair on the requirements of filing the Form 990.

2. Penalties for failure to file complete and accurate 990. Again, without sufficient definitions and standards and the training that explains the new processes it would not be fair to penalize individuals who have taken all measures to file the form appropriately.

3. Penalty for failure to file timely 990. Many nonprofits who utilize audit firms are serviced after higher paying clients, and therefore find themselves at the mercy of the firms to file the Form 990 when they get to them. This often results in the need for nonprofits to file for extensions. Often when the audit firm is not familiar with the various intricacies of Form 990 laws the draft form has to be corrected, and this takes additional time. The addition of an Audit Committee to review an organization's Form 990 also lengthens filing time. If the desired outcome is correct Form 990s, sufficient time must be allowed given the realities that nonprofit audits are the last to be completed by the audit firms. To apply the failure to file penalty after extensions greater than four months is unreasonable and unrealistic.

4. Electronic filing. NCNA has been working with other national organizations to support federal and state level electronic filing. We support these efforts if they do not cause an undue hardship on smaller nonprofits and support is provided to them to comply with electronic filing requirements. This effort must be coordinated with state-level efforts. Recent experience in the state of Colorado revealed that many nonprofits did not have the technological capacity to register

with their Secretary of State's office when they were required to e-file. As a result, many were out of compliance the day the law became effective.

5. Standards for filing. This effort is welcomed and encouraged. Standards should also be consistent with efforts for uniform charts of accounts (UCOA) that go hand in hand with financial reporting requirements , as well as consistent with the requirements of the State Attorney's or State Charity Official's offices.

6. Independent audits or reviews. This proposal is certain to place a significant financial and administrative burden on most, if not all, nonprofit organizations. The recommended threshold is too low and we recommend that a higher threshold be considered (see efforts in New York State and California for examples). The recommendation to change the audit firm every five years should be considered in the context of three pressing realities: a) in small states with few firms knowledgeable about the nonprofit sector there are few options; b) re-bidding on audits often leads to increases in the cost from 25% and upward, and c) if an organization's primary source of revenue is program-restricted with little or no administrative costs, it would not have the resources needed to pay for an audit. This requirement begs the question: Who will pay for the required audits?

   Further study of the current requirements applied to nonprofits shows that the federal government requires organizations that receive $500,000 in public money to complete an audit (A-133). Consistency with existing rules is advisable.

7. Enhanced disclosure of related organizations and insider transactions. No concerns with this suggestion; it appears on surface to be a good idea.

8. Disclosure of performance goals, activities, and expenses in Form 990 and in financial statements. The specifics on how these disclosures will be reported should be considered in the context of a fuller discussion on reforms of Form 990. We should be mindful of the fact that Form 990 was developed as a financial reporting tool and not a management disclosure tool. State officials' involvement in reporting of performance goals and activities should be considered before we attempt to extend the uses of Form 990 beyond its capabilities and appropriateness.

9. Disclose investments of public charities. What is the definition of "smaller public charities"? If the information is included on the publicly available Form 990, there is no need to make it available on another form. This would be redundant and a waste of an organization's resources.

F. Public Availability of Documents

1. Disclosure of financial statements. The disclosure of financial statements should be required at the end of the organization's fiscal year and not month by month. The report can be filed through the organization's annual report, posting on its website, and the Form 990 (if filed).

2. Web-site disclosure. If an organization does not have the capacity to file such documents on their website they can link to other sources of information, such as Guidestar or the IRS's own database of charities.

3. Publication of final determinations. Allow for the organization to provide its response to the reasons for the audit in order ensure that it has been granted the right to make its case to the public.

4. Require public disclosure of Form 990-T and affiliated organization returns. Allow for additional information provided by the organization about its rationale for engaging in activities considered under Unrelated Business Income Tax. There are often misleading interpretations as to why organizations engage in such efforts and this provides one opportunity for the public to become better informed as to the organization's intentions.

5. Require public corporation filing of charitable giving return. The publicly-traded corporation's filing should match the nonprofit's filing as well.

G. Encourage Strong Governance and Best Practices for Exempt Organizations

1. Board Duties. The requirement that an "individual who has special skills or expertise has a duty to use such skills or expertise" may cause a problem in our litigious society. For example, lawyers on boards are reluctant to provide legal advice to an organization because of potential liabilities. Many of the duties outlined in the *Staff Discussion Draft* are consistent with the general practices of boards. The requirement of changing auditors every five years, for those organizations conducting audits, might on surface be a good idea but could lead to more mistakes in filings (of both audits and Form 990s). In addition, exceptions may have to be made in communities where there is not an abundance of auditors available for nonprofits. The duties outlined in the draft document raise serious concerns about the board-management line of responsibility. The board's role as the governing and policy body should not cross over into the responsibility of the management, which is hired by the board to implement programs and achieve the organization's stated objectives and organizational priorities. Once again, seeking direct input from those

organizations that will be impacted by significant changes in current practices is advised.

2. Board Composition. To establish an arbitrary range of three to fifteen board members does not take into account the extensive board development of long established organizations that have board involvement in program and administrative committees or the implications of the size of an organization. The recent suggestion that boards incorporate an Audit Committee as part of their standing committees, for example, required NCNA to overextend our board members with two to three committee assignments. Other organizations, such as those that are membership based, have elaborate formulas to ensure that their boards are reflective of their constituency, and this might require more than twenty members.

3. Board/Officer Removal. This oversteps the bounds and capabilities of the IRS's authority and is best left with boards through internal policies and oversight at the state level.

4. Government encouragement of best practices. If preferential treatment is afforded to those and only those organizations that are accredited by IRS designated entities, the IRS and those entities must be open and transparent in their process and make information easily available on how to gain and seek accreditation. Participation in the Combined Federal Campaign is often restricted to certain types of organizations (i.e., human service) and therefore organizations that are not allowed to participate will be unfairly penalized due to the nature of their work. Using a few selected entities to assign the "seal of approval" will eventually leave out hundreds if not thousands of worthy organizations.

5. Accreditation. This is an example of a good idea that would be difficult, if not impossible, to implement fairly, cost efficiently, and reasonably. To place the additional financial hardship on organizations to pay fees to obtain and retain their accreditation status will jeopardize those organizations that are not in the position to pay for the status. This raises questions as to the legitimacy of such efforts if one is paying for the "seal of approval".

   The *Staff Discussion Draft* notes the efforts of our own members: Maryland Nonprofits, Ohio Association of Nonprofit Organizations, Pennsylvania Association of Nonprofit Organizations, Georgia Center for Nonprofits, and Louisiana Association of Nonprofit Organizations, in addition to the Minnesota Council on Nonprofits, Utah Nonprofits Association, and North Carolina Center *for* Nonprofits. These and other management support organizations have been challenged by the nonprofit sector's own calling for greater guidance on how to operate, stimulated in part by external calls for greater accountability and by

their own desires to operate under the strictest adherence to rules and regulations.

Investments in efforts such as those of our member state associations is a step in the right direction as long as there is ample time, energy, and outreach to the thousands of nonprofits that do not have ready access to such programs. If the $10 million were applied to the 1.5 million nonprofits across the country, this would equate to approximately $6.67 per organization, for the *first year.* Maryland Nonprofits has found the accreditation process to be far more extensive and time consuming than originally determined.

If we move towards the accreditation process and use the determination as a status for preferential treatment for government and other revenue sources, we ought to be cognizant of the "real costs" of such an endeavor. The success of an accreditation process requires extensive follow-up and monitoring to ensure that organizations are complying with the standards of practice. This again is time- and staff-consuming and requires sufficient support to make it more than a perfunctory function. Certification may be appropriate for specific, highly developed and regulated subjects (i.e., hospitals, higher education) but not easily applied and applicable to general nonprofit categories.

6. Establish prudent investor rules. On the surface this sounds like a reasonable recommendation.

H. Funding of Exempt Organizations and for State Enforcement Education

NCNA has long advocated that the foundation excise tax (2%) be applied to its intended purposes. One of the major reasons we find ourselves in the predicament we are in today is that IRS EO Enforcement entity has not had sufficient resources to catch the "bad apples". Applying the tax revenue for its intended purposes would go a long way to resolving many of the abuse cases.

Attaching additional fees to already strapped nonprofit organizations, plus adding other fees (accreditation, penalties), will punish those that try their best to comply with the existing rules and regulations. It is not just the burden placed by extra financial costs, but the extra time necessary to learn about the new requirements and incorporate new procedures – which for the most part are not funded activities. The result takes precious time away from mission driven activities. This is especially troubling in a time when nonprofits are being admonished for being less efficient and spending too much on overhead and administrative costs versus mission costs.

Government's desire to work in partnership with existing groups to educate other nonprofits, so called infrastructure organizations, is another effort we heartily

support. It has long been the dream of NCNA and its members to have government support for "one stop centers" that provide all the necessary information for starting up, shoring up, scaling up and shutting down nonprofits. Education is the key to preventing bad things from happening to good charities. The experience of many of our members reveals that nonprofit staff, board and volunteers are trying to do the best they can with limited resources and information. The challenge is getting the right information to them in a timely and efficient way, as this is the only way to build their capacity and strengthen their organizations.

Currently nonprofit organizations must comply with local, state and federal (IRS primarily) sets of rules – many of which come with their own reporting requirements and filing fees. Efforts that support uniformity of financial and program reporting across the three levels of the public sector would streamline efforts and would be supported by NCNA and its members. Attempts to improve state level enforcement, in consultation with the nonprofits in those states, is far more advisable than leaving enforcement in the hands of the federal government.

I. Tax Court Equity Authorities, Private Relator and Valuation

Our general concern with the proposals outlined in the draft document is the possibility of abuse of the provisions based of differences of opinion on philosophical and ideological grounds, rather than questions about legality. This can result in overcrowding the court system and diverting precious resources to legal fees and costs.

Closing

NCNA looks forward to working with the staff and members of the Senate Finance Committee as it moves forward in its efforts in the area of nonprofit regulation and enforcement. Our linkage to local community-based organizations through state associations can provide valuable feedback to the committee as you finalize or reinforce existing legislation. You can become more informed about our organizations and our state association members by logging on to our website at www.ncna.org.

Statement Submitted by Audrey R. Alvarado, Executive Director, National Council of Nonprofit Associations, 1030 15th Street NW Suite 870, Washington, DC 20005; 202-962-0322; aalvarado@ncna.org